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# THE BANKING AND CURRENCY ACT OF 1913. II

## VII

Apart from the effect of the Federal Reserve Act of 1913 on our credit system, its relations to our currency system will have special interest to the general public, notably to those who have been concerned with the struggles over government issues and free silver. For a long time this country has been facing a decision on the question whether the forms of money (irrespective of the standard, be it gold or silver) needed as media of exchange by the daily round of business should be issued by the government, after the example of the United States notes (i.e., greenbacks), or by the banks, after the example of national bank notes.[1] In order to determine the bearing of the new law on this general question, a statement of the provisions regarding note-issues will first be given.

No change is made in regard to any of the following forms of money: gold, gold certificates, silver, silver certificates and United States notes. Indeed, all past questions touching the standard were definitely settled by a remarkable amendment in the House, now embodied in sec. 26 of the new act, which emphasized the maintenance of the gold standard:

Nothing in this Act contained shall be construed to repeal the parity provision or provisions contained in an Act approved March fourteenth, nineteen hundred, entitled "An Act to define and fix the standard of value, to

[1] Cf. the author's analysis in *Latter-Day Problems*, in chap. x, "Government vs. Bank Issues" (1909) pp. 273–98.

maintain the parity of all forms of money issued or coined by the United States, to refund the public debt, and for other purposes," and the Secretary of the Treasury may, for the purpose of maintaining such parity and to strengthen the gold reserve, borrow gold on the security of United States bonds authorized by section two of the Act last referred to or for one-year gold notes bearing interest at a rate of not to exceed three per centum per annum, or sell the same if necessary to obtain gold.

Likewise, the only provision affecting the greenbacks is that (sec. 7) which devotes the net earnings from Reserve Banks accruing to the United States "to supplement the gold reserve held against outstanding United States notes," or to reduce the bonded indebtedness, at the discretion of the Secretary of the Treasury.

The direct purpose of the new act is to replace the national bank notes, within a period of twenty years or more, by Federal Reserve notes. These notes are described as follows (sec. 16):

Federal reserve notes, to be issued at the discretion of the Federal Reserve Board *for the purpose of making advances* to the Federal reserve banks through the Federal reserve agents as hereinafter set forth and for no other purpose, are hereby authorized. The said notes shall be *obligations of the United States* and shall be receivable by all national and member banks and Federal reserve banks and for all taxes, customs, and other public dues. They shall be *redeemed in gold on demand at the Treasury Department* of the United States, in the City of Washington, District of Columbia, or in gold or lawful money at any Federal reserve bank.

These notes can be obtained only by a Federal Reserve Bank, on the deposit of an equal amount of commercial paper as defined by sec. 13. Each note issued shall carry on its face the distinctive letter and serial number of the Reserve Bank putting it out, thus making each Reserve Bank responsible for the redemption of its own issues. That is, instead of United States bonds, as in the case of national bank notes, the security behind the Federal Reserve notes is to be commercial paper; while these notes are also "a first and paramount lien on all the assets" of the issuing Reserve Bank. The Federal Reserve Board, through its federal reserve agent in each Reserve Bank, may charge the latter a rate of interest on these notes, at its option; and the Board has the right, if it so chooses, to refuse entirely any application for notes. The Comptroller of the Currency shall provide the plates and dies, have a supply of notes

ready for each bank, and charge all expenses to such banks. There is no limit to the total amount of such notes; and there is no tax when issues pass beyond a certain sum, except the possible charge of a rate of interest, as just mentioned. In effect, the supply of these notes is directly related to the supply of rediscounted commercial paper, although the whole of any rediscount is not, by any means, likely to be paid out in notes. So much for the methods of issuing these notes.

As regards the contraction of the notes when not needed, redemption is provided for by gold reserves of 40 per cent against notes outstanding. No Reserve Bank shall pay out the notes of any other Reserve Bank under a penalty of 10 per cent; but it is obliged to present such notes for credit or redemption to the bank that issued them. Likewise, Federal Reserve notes presented at the Treasury are redeemed out of a gold fund left with the Treasury by the Reserve Banks which shall not be less than 5 per cent (but counting as part of the 40 per cent reserve); and the Treasury will remit any notes thus redeemed to the respective Reserve Bank for reimbursement. A Reserve Bank, although required to hold reserves of 40 per cent in gold against its outstanding notes, may redeem them either in gold or lawful money. When a Reserve Bank wishes to reduce its liability for Federal Reserve notes, even if its own notes are not obtainable, it may deposit with the Federal Reserve Agent any Federal Reserve notes, gold, gold certificates, or lawful money. By these provisions, it is obvious that contraction of notes, not needed by the public, is fully provided for. In short, elasticity of note-issues—expansion in time of need and contraction when the need has passed—is fully provided. Furthermore, there can be no possible question as to their safety, secured as they are, first, by a gold reserve of 40 per cent; second, by the pledge of picked commercial paper to the par value of the notes; third, by a first lien on all the assets of the Reserve Bank; and, finally, by the guaranty of the United States —an obligation not likely ever to be called upon, in view of the prior protection.

The language of the act (in sec. 16) relating to Federal Reserve notes is equivocal. It is an obvious attempt to satisfy those who

believe in government issues of paper money; while at the same time it is not the purpose seriously to impair the real functions of the issues as bank notes. Thus the final outcome of the time-honored dispute, so far as reached by this act, seems to be in essence and in practical operation a settlement in favor of bank notes; for the Federal Reserve notes are in no real sense government issues. The Treasury has no power to issue them in payment of governmental expenses; since the initiative must come from the Reserve Banks, and only on the offer of commercial paper originating in a private business transaction. Although not so stated literally, the notes are liabilities of the Reserve Banks, since they must redeem them, and since the notes are a first lien on all the assets of such banks. To state that the notes are the obligations of the United States and may be redeemed at the Treasury is only "a frill," of no practical import; since it is inconceivable that the government should ever be called upon to meet this obligation. To say that, in issuing the notes, the Treasury is "making advances" to the Federal Reserve Banks is meaningless (and, if it serves a political purpose, no harm is done); since the action of the Board in passing out notes in return for a pledge of commercial paper is as purely administrative as the present action of the Comptroller in handing over printed national bank notes in return for a pledge of United States bonds. Nothing in the words of the act can be construed as making these notes government issues, any more than national bank notes are government issues.[1] On this outcome, and on the escape from serious monetary error, the country is to be congratulated.

The new law looks forward to a new basis for the bank-note circulation which has been based on United States bonds. These notes are eventually to be displaced with Federal Reserve notes based on commercial paper. This displacement, involving the disposal of $740,000,000 of United States bonds now used to secure circulation, will be treated later.

A national bank entering the new system is not, however,

[1] It is not worth while to give attention to the claim that Federal Reserve notes are "fiat money," because, being government obligations, the government makes no provision for their redemption. Other provisions remove them from this imputation.

obliged to give up its present circulation; and the withdrawal of national bank notes by existing national banks is tied up with the disposal of the bonds to which the circulation privilege is already attached. Nor are national banks obliged to present their bonds for exchange into others having no circulation privilege under sec. 18, unless they choose. Consequently, the displacement of existing national bank notes by Federal Reserve notes will be long deferred. If it had been possible to dispose of the bonds amounting to $740,000,000 to the full satisfaction of the banks, how could an equal amount of Federal Reserve notes be issued to take their place? Since the latter were to be secured only by commercial paper, instead of bonds, it follows that there would have been a considerable contraction of bank notes, unless the Reserve Banks had discounted paper on hand to at least $740,000,000. Obviously, this sum could not be counted on; and a contraction of the currency would not have been politically wise. Hence the provisions of the House bill, allowing a more or less rapid substitution of reserve notes for national bank notes, were dropped by the Senate. Of course, under the new act, quite independently of the national bank circulation, Federal Reserve notes may be issued at any time to any amount according to the provisions of sec. 16. If issued, they would be an addition to the existing national bank circulation; and the security behind them would be commercial paper, not bonds.

If, however, national banks prefer to sell their bonds they may do so, after December 23, 1915, and within a period of twenty years thereafter, in limited amounts each year (sec. 18). The bonds thus disposed of by the banks are to be taken over by the Federal Reserve Banks; and the latter are then to be allowed to take out national bank notes on depositing these bonds with the Comptroller, in the same way as national banks do now; although they are not obliged to do so.[1] To the extent that Federal Reserve Banks should not take out notes on the bonds they have acquired there

[1] If these notes are issued to Federal Reserve Banks under the same conditions as to national banks, the former must pay the tax of one-fourth of 1 per cent, if the bonds pay only 2 per cent; but in sec. 7 the former are free from federal taxation. Cf. Conway and Patterson, *The Operation of the New Bank Act*, pp. 138–39.

would be a contraction of the national bank circulation. But it is planned to prevent any considerable contraction of the national bank circulation, even if the national banks dispose of their bonds (cf. sec. 4, Eighth). The final disposal of these bonds by the Federal Reserve Banks will be discussed later.

Understanding that the national bank circulation is not likely to be reduced for the present, while the Reserve Banks may at any time add to the existing monetary supply, are we to expect, so far as notes are concerned, an undesirable expansion? By expansion must be meant the tendency to grant loans, through the too great ease of issuing notes or granting credits, without due regard to the soundness of the transaction. So long as loans are carefully restricted to safe loans based on an actual exchange of goods no swelling of liabilities occurs which must be finally reduced by forced liquidation. That is, undue expansion has its origin in excessive, or unsound, loans. An extension of bank notes, then, can cause expansion only so far as it aids in an expansion of loans. If so, how will the note-issues under the new act work?

An increase in bank notes can be used for two general purposes: (1) to satisfy the need of a medium of exchange in the hands of the public; or, (2) to supply bank reserves. In the former case, if pocket money and till money is already sufficiently supplied, then, unless the monetary customs of the people have changed, no more bank notes will remain in circulation, provided they are redeemable in gold or lawful money. In the latter case, the Federal Reserve notes cannot be kept as reserves by member banks. But, it is said, they may be presented, the same day they are obtained on a loan, for gold and lawful money by which reserves could be enlarged. On the contrary, if a member bank wished to increase its reserves by a rediscount, it would not need to draw notes at all, but would leave the proceeds of the loan to its credit at the Reserve Bank, in which form it is *ipso facto* added to its reserve account. There still remains, however, the possibility of getting Federal Reserve notes and exchanging them for lawful money at a non-member bank which can use Federal reserve notes as reserves.[1] There would, however, be no more reason for this action than for the one

[1] Cf. Conway and Patterson, *op. cit.*, p. 152.

just mentioned, since it would be less trouble to leave the proceeds of a loan at a Federal Reserve Bank on deposit where it would count as reserve. For these general reasons, then, there does not seem to be any ground for apprehension that the Federal Reserve notes will, *per se*, be so put into circulation as to cause expansion. If any such expansion is intended, it can be more easily accomplished, without the use of the notes, through loans, deposit accounts, and checks.

There are those, however, who measure expansion by the increase of prices. They probably hold that an addition to the circulation, according to the quantity-theory of prices, would raise prices; also, that an extension of loans, without the use of bank notes, would stimulate credit and raise prices.[1] Redemption, on the other hand, would always force a test of the solvency of the transaction on which the credit is based; thus credit is kept wholesome and normal, so long as unsound loans are prevented.[2] A possibility of undue inflation is suggested, it may be mentioned, by such a reduction of reserve requirements as would weaken the certainty of redemption; but this consideration could not apply to the Federal Reserve notes, under this act.

## VIII

The removal of a bank circulation secured by United States bonds having been determined upon by general consent, a practicable and just disposal of the $740,000,000 bonds has not been easily found. The largest part of these bonds yield only 2 per cent; solely as an investment they would sell below 70; but, since they have the "circulation privilege" (or right to serve as security for national bank notes) the demand for them by national banks in the past has kept them above par, some having sold even as high as 110. When the new bill appeared, the national banks were directly concerned with the possibility of losses on their bonds,

[1] Cf. O. M. W. Sprague, "The Federal Reserve Act of 1913," *Quarterly Journal of Economics*, February, 1914, p. 240.

[2] "The security against the consequences of inflation is not to be found in the limitation or extinction of notes, but in specie redemption for all liabilities, and in the encouragement given sound banking by steady oversight and publicity." C. F. Dunbar, *Economic Essays*, p. 185.

if the circulation privilege were withdrawn from them. In the proposed law the treatment of these bonds was the problem least well thought out.

When the Glass bill became known, June 18, 1913, it contained sections then numbered 18, 19, and 20. Sec. 18 provided that no national bank should issue notes in excess of the amount outstanding at the passage of the act; sec. 19 repealed the former acts requiring banks to hold bonds to the amount of one-fourth of their capital (if less than $150,000); and sec. 20 required the Secretary on application to exchange the 2 per cent bonds having the circulation privilege for 3 per cents not having this privilege (but payable 20 years from date and exempt from all taxation) to an amount each year not exceeding 5 per cent of the total quantity of bonds held by the Treasury, while, as fast as the 2's were refunded, "the power of national banks to issue circulating notes secured by United States bonds shall cease and terminate"; and at the end of 20 years all the 2's should be exchanged for 3's, and all national bank notes be recalled and redeemed.

To most politicians the note question is of primary importance; indeed, to allow banks under any circumstances to issue notes is to grant the "money power" a privilege. Conferences of leaders were held. Senator Owen, chairman of the Senate committee, demanded the omission of secs. 18, 19, and 20 in order that the question might be left to future legislation; and he gained his point. Then, on the representation of a committee of the American Bankers Association, these sections of the bill were reinserted; and on June 26, 1913, the bill including them was introduced into the House and Senate.

As these sections stood, the 2's could not be sold in the future to secure circulation, since no more national bank notes could be issued than were outstanding at the passage of the act; and the only outlet would be their exchange for 3's. On June 28 the financial columns of the press noted a decline in the price of the 2's to par. At the best they could not sell higher than the 3's into which they were to be exchanged; and European states were not able to borrow at par at 3 per cent. Just at that time a tendency of the interest rate on permanent investments toward a higher level showed

itself. It might be that within the term of 20 years the 3's might not be worth par, it was said; thus, somehow, the belief spread that on the passage of the act the circulation privilege would be practically taken away. But, whatever the reason, timid holders of the 2's began to throw them on the market; hence, as the demand was small, a very few offers were sufficient to send down the price, and during July they were quoted at 95.

United States bonds (including 2's) had also been used to secure government deposits with the banks (some $50,000,000). If by the new act government deposits were to be transferred to the Federal Reserve Banks, then the demand for 2's (or any other United States bonds) would to that extent be diminished.

This embarrassing situation[1] brought out a statement from Washington about the middle of July that sec. 20 would be so modified as to allow all banks to take out circulation on the 2's as long as they were not exchanged for 3's; that the exchange of 2's into 3's would be permissive; and that at the end of 20 years the holder of 2's would receive par and accrued interest in cash. In effect, the circulation privilege was to be restored. It was also stated that sec. 18 had been left in the bill by error; and when the bill was presented to the House caucus August 15, sec. 18 had been omitted. Moreover, at this time (July 31) Secretary McAdoo announced he would deposit $25,000,000 to $50,000,000 of government funds with the banks of the South and West to relieve any autumnal stringency. To get these deposits banks must have outstanding at least 40 per cent of their authorized circulation, and if they pledged government bonds these would count as par against

[1] As a consequence of the fall in the prices of the 2's, Secretary McAdoo on July 28, 1913, made the following statement to the public:

"The 2 per cent bonds are worth par, notwithstanding their decline in the New York market, a decline due not to any impairment of their intrinsic value, but almost wholly to what appears to be a campaign waged with every indication of concerted action on the part of a number of influential New York city banks to cause apprehension and uneasiness about these bonds, in order to help them in their efforts to defeat the currency bill."

The banks retorted that it was unlikely they would try to impair the value of their own assets amounting to $740,000,000. On the other hand, the statement might have retained radical support in Congress for a bill supposed to be antagonized by the large banks.

deposits. To that extent the demand for United States bonds would be increased and their price be raised.[1]

Finally, in the later stages of this legislation, the present provisions regarding bonds were inserted in sec. 18 of the new act. After December 23, 1915, and for 20 years thereafter, any member bank wishing to retire its circulation may offer its bonds at par to the Treasury of the United States; at the end of each quarter, the Federal Reserve Board may require each Federal Reserve Bank to purchase a certain proportion of the bonds offered. The Reserve Banks may then take out notes, under the same conditions as national bank notes, equal in amount to the bonds they have purchased. If they do this, there will be no contraction of notes secured by bonds.

It is expected, however, that Federal Reserve Banks will not present to the Comptroller all their bonds as security for notes; since any Reserve Bank may have its 2 per cent bonds against which no circulation is outstanding refunded, one-half into 30-year 3 per cent gold bonds without the circulation privilege, and one-half into one-year gold notes of the United States bearing 3 per cent interest, without the circulation privilege. Thus, instead of the 2's, it may have long-term 3 per cent bonds which it can sell in the open market, and one-year notes which will be highly useful in borrowing gold in any foreign market. To the extent that Federal Reserve Banks refund their bonds the national bank circulation will be reduced; but at no time will the bonds held by member banks lose their circulation privilege, and after two years they can be sold at par in amounts of not more than $25,000,000 in any one year. It follows, therefore, that not all the bonds can be disposed of in 20 years.

## IX

The lending power of a bank, whether the loan is carried through by notes or by a deposit-account given to the borrower, is influenced by the regulations affecting reserves, which are the cash

[1] Furthermore, state and municipal bonds, etc., other than bonds of the United States would be accepted at a valuation of 75 per cent, and prime commercial paper at 65 per cent. This was the first time commercial assets were ever permitted under the act of March 4, 1907 (sec. 3) to be used as security for government deposits. Since the passage of the present act, it has no further importance, except that it went far beyond the action of Secretary Shaw, so much criticized at the time.

means for meeting demand liabilities. On this important feature, it should be noted that the plan of the National Monetary Commission made no changes in the old system of reserves. Under the national banking system, country banks were obliged to hold 15 per cent reserves in lawful money against deposits, of which 9 per cent could be kept with banks in reserve or central reserve cities; the banks in the forty-seven reserve cities were obliged to hold reserves of 25 per cent, of which 12½ per cent could be kept with banks in central reserve cities; while banks in the three central reserve cities had to maintain reserves of 25 per cent. Moreover, the required redemption fund of 5 per cent of outstanding circulation could be counted toward reserves for deposits. This redepositing of reserves in trade centers arose for business reasons: customers of local banks needed drafts, or exchange, on cities where they purchased goods; and such banks had to keep funds there on which to draw. That is, redepositing of reserves was due to the need of exchange. Whether there were reserve laws or not, funds would have to center where the most goods were bought and sold. Some centralization of reserves in this way was normal and inevitable.

By selling exchange on large city banks a local bank creates demand liabilities at a distance; yet it has demand liabilities in its deposit accounts at home. The two things are different and lead to much confusion of mind. The sum kept with a city correspondent to cover exchange is really only a checking account, and in no sense a real reserve in cash that can be called for on demand; it is constantly being wiped out and replenished by miscellaneous items. But under the delusion that these funds are reserves (strengthened by the fact that the law permits them to be called legal reserves), local banks seem to think they can call on them in time of stress; then, of course, they cannot get the cash, and are highly indignant. In truth, checking accounts to cover exchange are not real reserves. This consideration should be kept in mind in studying the effect of the reduction of the percentages for reserves in the new act.

For demand deposits, in the new law, a country bank is required to maintain reserves of 12 per cent; three years after the establishment of the Federal Reserve Banks, 4 per cent must be kept at

home, 5 per cent in the Federal Reserve Bank, and the remaining 3 per cent, either at home or with the reserve bank at the option of the country bank.[1] That is, after three years, no funds left with city correspondents can be counted as legal reserves. In short, funds to cover exchange, so long as it is drawn on city correspondents, must be carried independently of legal reserves. On the other hand, if exchange is drawn in the future on the Federal Reserve Banks, or branches (instead of on other banks, as now), funds counted as reserves will still be used to cover exchange. Therefore, the reduction in the minimum requirement from 15 to 12 per cent reserve is more nominal than real.

A reserve city bank, in the new act, is required to maintain reserves of 15 per cent of its demand deposits; after three years, 5 per cent shall be kept at home, 6 per cent in its Federal Reserve Bank, and the remaining 4 per cent either at home or with the Reserve Bank at option.[2] As with country banks, no deposits in other banks will then count as legal reserves.

A central reserve city bank is required to hold reserves of 18 per cent against its demand deposits, of which, from the beginning, 6 per cent must be kept in its own vaults, 7 per cent in its Federal Reserve Bank, and the remaining 5 per cent either at home or with its reserve bank at its option.

Inasmuch as items passing from a depositing bank to its reserve agent should not be counted as reserves until collected, they should not be included by the reserve agent as deposits on which reserves are to be computed. The new act, therefore, enacted (sec. 20) that "in estimating the reserves required by this Act, the net balance of amounts due to and from other banks shall be taken as the basis for ascertaining the deposits against which reserves shall be determined. Balances in reserve banks due to member banks shall, to the extent herein provided, be counted as reserves."

For all these classes of banks a new distinction is introduced between demand and time deposits: demand deposits comprise

[1] In the transition period of three years the bank must keep 5 per cent at home; in the Federal Reserve Bank for the first twelve months 2 per cent; and for each succeeding six months an additional 1 per cent, until 5 per cent is reached.

[2] In the transition period of three years the bank must keep 6 per cent at home; in the Federal Reserve Bank for the first twelve months 3 per cent; and for each succeeding six months an additional 1 per cent, until 6 per cent is reached.

all those payable within thirty days, and time deposits all those payable after thirty days, including savings accounts, etc., subject to thirty days' notice. Any bank is required, in addition to the above requirements for demand deposits, to hold only 5 per cent reserves against time deposits. As nearly as can be estimated, about one-third of the deposits of country banks are time deposits; of reserve city banks, about 8 per cent; of central reserve city banks, about 1 per cent. Taking into account both the reduction of reserves against demand deposits, and that due to the low rate on time deposits, the nominal reserves (irrespective of redepositing) have been lowered by more than one-third, as may be seen from Table I, based on the last reports of the conditions of national banks:

TABLE I

[000,000 omitted]

| March 4, 1914 | Net Deposits | Total Time Certificates | Total Savings Deposits | Total Time Deposits | Required Reserves under Old System | Required Reserves under New System | Reserves Released under New Act |
|---|---|---|---|---|---|---|---|
| Country Banks.. | $3,761 | $485 | $777 | $1,262 | $564 | $363 | $201 |
| Reserve City Banks........ | 1,970 | 59 | 93 | 152 | 492 | 280 | 212 |
| Central Reserve City Banks... | 1,773 | 15 | 1 | 16 | 443 | 317 | 126 |
| Totals...... | $7,504 | $559 | $871 | $1,430 | $1,499 | $960 | $539 |

Although the nominal reserves, especially of country banks, have thus been lowered, there remains the problem of the effect on the banks and on business of the transfer of reserves, if any, from the present reserve city banks to the Federal Reserve Banks. As to the sums which must be at once moved to comply with the law, the computations[1] which have been made show clearly that the

[1] Cf. W. A. Scott, "Banking Reserves under the Federal Reserve Act," *Journal of Political Economy*, April, 1914.

[000,000 omitted]

| January 13, 1914 | Country Banks | Reserve City Banks | Central Reserve City Banks |
|---|---|---|---|
| Total cash holdings.................... | $284.0 | $286.6 | $429.2 |
| One-half deposit of reserves ........... | 37.4 | 28.6 | 55.3 |
| 3 per cent subscription to capital....... | 29.8 | 13.4 | 10.4 |
| Reserves required at home............. | 186.9 | 114.4 | 94.8 |
| Balance of cash holdings .............. | 29.7 | 112.2 | 268.5 |

See also the figures of Conway and Patterson, *op. cit.*, pp. 251–52, 259, 267–69, 272, 275–76, 299, 301, 306.

cash holdings of the various classes of banks are more than sufficient to cover the transfers of the reserves, the payment of the required 3 per cent on the capital subscription of 6 per cent upon capital and surplus, and to retain enough reserves in their own vaults to meet the requirements of the act. That is, it would not be necessary for banks to call upon their present reserve agents to cover the initial payments to the Federal Reserve Banks; but it is assumed that one-half of the reserves to be first paid into the Federal Reserve Banks would be obtained (as permitted in sec. 20) by deposit of eligible commercial paper (as described in sec. 13). In short, these figures present the minimum transfers in initiating the new system. Additional payments will go on during the first three years.

In viewing the effect of the transfer of funds on business loans, it is to be noted that, of course, the whole of the amount deposited by local banks in reserve city banks is not needed merely to cover exchange. As is well known, the payment of 2 per cent interest on deposits by reserve agents attracts funds when idle at home; and a large deposit account with its city correspondent gives the local bank corresponding advantages of treatment. In the last report the figures were as given in Table II.

TABLE II

[000,000 omitted]

| March 4, 1914 | Cash and 5 Per Cent Redemption Fund | Deposits with Reserve Agents |
|---|---|---|
| Country Banks | $291 | $551 |
| Reserve City Banks | 261 | 286 |
| Central Reserve City Banks | 449 | ..... |
| | $1,001 | $837 |

The total net deposits of national banks subject to reserve requirements at that date were $7,504,000,000. Thus the actual cash of $1,001,000,000 was only 13.3 per cent of deposits; since the $837,000,000 of deposits with reserve agents was not cash. Hence the demand of member banks upon their reserves in the reserve cities, if made, for transference to Federal Reserve Banks would really fall upon the $1,001,000,000 of cash actually held in the present system.

The important consideration, however, lies in the lending power of the banks after and because of these transfers. With the balances left over in their reserves, can they still care for their customers? That question is obviously the one which is forcing the banks to be cautious with loans until the adjustment is finally completed. There are, however, two matters which may relieve any possible tension. In the first place, the above computation has not called for withdrawals from reserve agents. It is well to be on the safe side in assuming this; for the present reserves with reserve agents could not be called upon to any extent in cash, since they are themselves the basis of loans made by the reserve agents. But, in the second place, the most important and effective method of taking care of the needs of customers in the transition period, and the one which would keep credits flexible, would be the rediscounting of short-time paper by member banks at the Federal Reserve Banks. The immediate effect of such a rediscount would be an increase of the reserves of the member bank, so long as the proceeds of the rediscount were left with the Federal Reserve Bank.

In addition, the use of government deposits in this transitional period would be a very important element. The deposits of the United States held by national banks is about $58,000,000; while the other funds of the Treasury would allow the deposit of a much larger sum with the banks. Instead of placing large amounts with Federal Reserve Banks at the outset, it may be wise to aid the member banks by additional deposits.

As a counter-weight to this possible restriction on loans, it should be kept in mind that the deposits of funds with city correspondents to cover exchange would no longer be so necessary, if instead exchange is drawn on the Federal Reserve Bank where funds exist to cover such drafts. To be sure, the payment of 2 per cent interest on deposits with the present reserve agents, and the tendency to continue long-established relations with these agents, will work to retain the present exchange methods and to keep funds with present city correspondents.

The general effect of the changes in the reserve system seem, on their face, to make easier an expansion of credit. That is, less cash reserves need to be carried; and member banks would have no

reason for carrying as high reserves as in the past, if they hold short-time paper such as they can use in getting notes from the Federal Reserve Bank. And yet, in the transitional period, we are likely to see more or less caution and restriction of credit. That is, at the start, the tendencies toward expansion and restriction very nearly balance each other.

As concerns the reserves of the Federal Reserve Banks, as distinct from member banks, there is a requirement of a 35 per cent reserve against deposits to be kept in gold or lawful money; and against outstanding Federal Reserve notes a reserve of 40 per cent in gold. Any reserve requirements specified in this act, however, may be suspended for thirty days (and later for fifteen days at a time) provided a graduated tax is imposed on the deficiencies. Further it is enacted (sec. 10):

> That when the gold reserve held against Federal reserve notes falls below forty per centum, the Federal Reserve Board shall establish a graduated tax of not more than one per centum per annum upon such deficiency until the reserve falls to thirty-two and one-half per centum, and when said reserve falls below thirty-two and one-half per centum, a tax at the rate increasingly of not less than one and one-half per centum per annum upon each two and one-half per centum or fraction thereof that such reserve falls below thirty-two and one-half per centum. The tax shall be paid by the reserve bank, but the reserve bank shall add an amount equal to said tax to the rates of interest and discount fixed by the Federal Reserve Board.

Under the provisions of the act, a Federal Reserve Bank might carry no gold at all behind its deposits, and only the 40 per cent of gold behind its notes; and even then it could redeem its notes in lawful money.

## X

The Federal Reserve Act of 1913 undoubtedly opens an entirely new epoch in the operations of credit and currency. Possibly because the developments in credit and in the mechanism of exchange have produced momentous changes in the last fifty or seventy-five years, it is safe to say that an act which should fully meet the conditions of today must be more important than any previous federal statute, not even excepting the National Banking Act of 1864, or the Act of 1791 establishing the first United States

Bank. Certainly no previous measure has attempted to strike directly at the long-recognized rigidity of our credit system, which has itself led to unnecessary paroxysms of trade in the past, and which has also brought to light the underlying weaknesses of our currency system. For, wider and deeper than the inelasticity of our circulation has been the inelasticity of our credit system. And yet, until this act, practically the whole attention of reformers has been directed to creating an elastic note system. In the work of the Indianapolis Monetary Commission of 1898 this was eminently true.

So far-reaching a measure as this demands comparison with the great enactments of other countries, especially with the English Bank Act of 1844. That law was passed to meet a situation not unlike our own: gold redemption had been secured since 1821; crises had been disagreeably destructive; it was desired to have a note-circulation which would act like gold; as with us now, the use of checks drawn upon deposit-accounts had been growing; and it was generally believed that all difficulties were traceable to the note-issues. Then came the act of 1844, which set the notes off by themselves in the Issue Department; while the deposit and discount functions were relegated solely to the Banking Department. With what result? That the operations of credit, independent of the note-issues, could, through the Banking Department, provide the most effective of all media of exchange (the deposit-currency); they could expand with trade; they could develop overtrading and crises; they could produce all the results formerly charged solely to note-issues. The unintended lessons of the Bank Act of 1844 are the most important in our monetary literature. Although the act represented the doctrines of the Currency School, its actual operations were the triumph of the Banking Principle. So with our act of 1913: while to many the matter of chief importance has seemed to be the note-issues, the real heart of the measure is to be found in the purely banking functions of discount and deposit. Not only are these pivotal, but they dominate the whole question of the note-issues.

In our own country the struggles associated with the greenbacks and silver have centered attention on the circulation and the quan-

tity of it in use. They have influenced the attitude toward bank notes by leading some politicians to think that the issue of notes by banks would enable these banks to control the "money-market" and the credit operations of the country. Moreover, the last previous act (the so-called Aldrich-Vreeland Act of 1908), intended to protect the country against possible panics, was based throughout on the assumption that credit emergencies could be met by an issue of national bank notes through currency associations. Perhaps no other statement than that would be needed to explain why, in the serious emergencies in the autumns of 1912 and 1913, no resort was made to the act of 1908. So firmly intrenched is this idea in the minds of our public men that in the new law of 1913 the act of 1908 was extended for another year; and the present Secretary of the Treasury has assured the country that the act would be resorted to if necessary.

When a loan is made by a bank it creates a demand liability in favor of the borrower that can be met either by its own notes (or cash from its reserves) or by a deposit-account. Whether notes, or checks drawn on deposit-accounts, are used by the borrower depends on the kind of transaction, or on the business habits of the community where he wishes to make a payment. The elasticity so much extolled may be demanded in two different conditions. In the first place, the seasonal demand for currency in the autumn has exposed the inelasticity of both our note and credit systems. It has given strong support to those who think our troubles center in the currency. Why? Because in the past the demand both for strengthening reserves and for paying customers has been a demand for some form of money. Hence the emphasis on the need of an elastic currency; and so far as this need of actual currency exists, it is imperative. But this is only a part of the truth, and not the most important part of it.

In the second place, the demand which comes in time of a panic brings us to the very core of the matter. Here the real need is for elasticity of credit; although to many minds even panic conditions are supposed to demand treatment in the form of additional issues of notes. Where we have the deposit-currency well developed (as

in the United States and Great Britain), there is no lack of a medium of exchange. Even in the worst of the crisis, if a borrower can obtain a loan, he has no difficulty in getting a medium of exchange. Consequently, the need of forms of money is then of importance primarily as it affects the reserves of banks and their lending power. Of course, a bank's own notes cannot be used in its reserves. Hence the real need is to stop the drain on cash reserves, or to obtain that by which reserves can be replenished. How can this be done? And how does the new act afford help at this point?

In the past, the National Banking Act caused rigidity of credit through its regulations touching not only its note-circulation, but also its reserves; and most of all by the absence of all provisions for converting good commercial paper into a means of payment—whether the borrower calls for notes, or uses a deposit-account. That is, the system was so constructed that when customers were in the most trouble and most needed help—when bank reserves were being drawn down—the bank was obliged to refuse loans, to contract existing loans, to sell any available assets it had for cash, and to try to increase the ratio of its reserves to its demand liabilities. Under the new act, just the reverse will be true. In times of distress there will be no need of contracting credit; in fact, the only time when it may be necessary to contract credit will be to check possible expansion during a tendency to over-trade (which will be discussed later). So far as borrowers, or the public, need forms of money in exchanging goods, or for various other needs, Federal Reserve notes can be obtained so long as holders of good commercial paper demand such money. Therefore, irrespective of the elastic deposit-currency, there will be no inelasticity of a medium of exchange for the public; it can be had as needed, at any time.

But how does the act touch the reserves and the rediscounts so that it may bring about the much-desired elasticity of credit? This is the nerve center of the whole act. The pivotal provisions are those which allow any member bank to have certain kinds of short-time paper rediscounted at its Federal Reserve Bank. At this institution the loan creates in favor of the borrowing bank a deposit-account. Then the pith of the operation resides in the fact that all

sums kept on deposit at a Reserve Bank count as legal reserves for the given member bank. That is, the rigidity of credit-banking in the past, the destructive snatching for reserves, are displaced by a system which allows good commercial paper—under certain limitations—to be converted into lawful reserves. This is the process which directly touches the lending power of a member bank to its customers. Therefore, in a time of panic—if any such arrives—there will be no reason for a run on cash reserves, or, if there is a semblance of it, there will be a quick and ready way by which the reserves can be replenished. There can be no serious run on the cash by the public, because the member bank can furnish at will reserve notes, by making request for them at the Reserve Bank and having them charged against its deposit-account there. But it must still be kept in mind that banks deal primarily in credit, and only incidentally in money. A sale of goods, which forms the basis of commercial paper, is thereby coined into a means of payment, and gives rise to its own medium of exchange without necessarily calling on any forms of money. And yet the elasticity of the notes and of credit are, as they should be, linked together. In short, both notes and deposits (on which checks can be drawn) respond directly to the volume of commercial loans; and these loans are directly related to the general volume of goods bought and sold. Thus, automatically the amount of notes and the deposits adjust themselves to the needs of trade. This outcome is one which no system of notes directly issued by a government could possibly bring about.

The kind of paper made acceptable for rediscount under the decree of the Federal Reserve Board is all-important (sec. 13). The essential point in the new law is the distinction between mercantile and investment paper. It was not intended that the paper presented for rediscount should have been drawn to carry stocks, bonds, etc., or goods in warehouse held for higher prices; nor to aid in securing capital for fixed investment in irrigation, water-power, street-railway, manufacturing plant, or similar purposes. On the other hand, it was intended to encourage loans based on the movement of goods from the producer to the consumer.

Granting this general distinction, there remains the task of stating just what kind of paper in common use conforms to the spirit of the act.

About thirty years ago a change took place in our forms of paper. Previously, buyers of goods gave the sellers their notes for the allowed term of credit in payment for the goods, and these notes, usually indorsed by the seller, were discounted at the banks. This was, strictly speaking, "two-name commercial paper." Under this practice, in case of goods subsidiary to further manufacturing processes (like ore, pig iron, steel, and rails) there might be several notes in the hands of the banks covering substantially the same goods at different stages of manufacture. This practice has today practically disappeared.

The introduction of trade discounts[1] made it more profitable for the buyer to borrow at his bank and pay cash for his goods. Borrowers in good standing could thus pay cash; while those of poor credit created "commercial paper." That is, the one-name promissory notes of borrowers in good standing at the banks were the best paper offered; yet it was not directly based on the sale of goods. The advantage of this method was that it practically put trade on a cash basis. This development, moreover, seems to be peculiar to this country.

On the other hand, the modern practice has the disadvantage that it is not easy to know whether the borrower uses the proceeds of his loan to pay for goods, or whether he may use it for investment purposes; or in some fixed form that is not liquid. Moreover, the acceptable borrower, once given a certain line of credit, usually keeps up to his limit by renewals, or continuous loans, without clearing up his account by paying off his loans.

In addition it should be made clear that, besides the notes thus described, a concern may obtain large loans through the agency of note-brokers, who sell them to banks. These are the direct, unsecured obligations of the borrowers. The business of the note-broker has increased phenomenally with the growth of the trade

[1] This influence has been fully described in an article by the writer on "The Aldrich-Vreeland Act" in the *Journal of Political Economy*, October, 1908, pp. 509–12.

discount. If a borrower cannot obtain cash to take advantage of the trade discounts, with the aid of the note-brokers, his standing is obviously low.

The Federal Reserve Board, therefore, not being able to alter business habits at once, must try to establish rules which would admit the highest grade one-name promissory notes, but would demand evidence that the loan was not used for investment, but for strictly mercantile purposes. The discounting bank must be held responsible for such evidence. In this way, the spirit of the act will be recognized, although the paper is not "strictly commercial." Yet there will certainly arise a tendency to devise forms of paper, which, while consistent with the existence of trade discounts, will disclose more distinctly than the present promissory note the purpose of the borrower to use the loan for mercantile, and no other, purpose.

Such being the provisions of the new act regarding elasticity of credit, are there any dangers of expansion? Fortunately the essential functions of discount are not hemmed in by detailed legislative prohibitions; fortunately, one must say, because discounting must always remain a matter of judgment, and much must be left to the management. Yet, on the other hand, this very freedom from restraint might result, under unwise management, in inflation and danger. This is inherent in the very nature of banking; since under any system, good or bad, everything depends upon the kinds of loans made.

Even with this new act, it is not to be supposed that we shall never see any more crises. Crises are more or less inevitable, because an act of Congress cannot prevent human optimism from over-trading in goods. Thus no matter how perfect is the machinery of our credit system, it will register the spasms of trade. The essential point to be gained by a desirable system of credit is that it should not aggravate the inevitable disturbances which will arise in emergencies of business; in the past, our rigid laws magnified any departure from regular conditions. In Europe, the banking systems are such as to minimize, and not magnify, trouble; which is the reason why Europe in recent times has been free from destructive panics, while this country has abounded in them.

The elasticity of credit implies both expansion and contraction according to the needs of business. Since any loan may be carried through by a bank giving either its own notes (or other cash) or a deposit-account, expansion may be aided either by an over-issue of notes or by an excessive creation of deposit-accounts. In some quarters, it is assumed that expansion can be regulated by regulating the issue of notes, or by taxing them, or the like. This is not true to the extent supposed. As a medium of exchange in paying wages, for traveling expenses, and for retail transactions, a certain sum of notes is always needed; but amounts beyond that will normally return to the banks. If the notes could be used as reserves, they would enable banks to expand loans. But Federal Reserve notes cannot be used as reserves by member banks; and here is a check on undue expansion. The danger, however, may exist elsewhere; these notes, like present national bank notes, could be used by the 17,000 state institutions in their reserves. So much, for present purposes, as to expansion through the notes (which are not limited in amount).

Those loans, it should be noted, which result in deposit-accounts at Federal Reserve Banks (and which are not drawn down by requests for notes) directly increase the reserves of member banks until transferred by check. Thus the lending power of the member bank is more quickly and extensively enlarged by this process than by the issue of notes. Herein lies the pivotal question of over-expansion. Passing by the question of over-expansion through the issue of notes, it is desired mainly to study here that arising only from the use of deposit-accounts and checks, because these operations are less understood and are more elusive. Here the possibility of expansion is even greater than in connection with notes, because the proceeds of a loan at a Reserve Bank, if left there, at once count as reserves, and permit another increase of loans.

To this possibility of serious expansion, what are the practical checks to be found in the bill? They may briefly be listed as follows:

1. Against notes the Reserve Bank must carry 40 per cent gold reserves; and against deposits 35 per cent reserves in gold or lawful money. But expansion will first develop in the member banks. They are not required to keep as large reserves as before against deposits (carrying, of course, no reserves

for notes). They can make more profit with the same reserves by carrying more loans. Thus, there is no restriction here, except that of refusal of loans by the Reserve Bank.

2. In Europe the real control over expansion is in the rate of discount charged to the borrower. So must it be here, if it is raised early and not after the expansion has arrived; but watch must be kept on the particular bank beginning to expand its loans, and the treatment must be individually applied at the source.

3. A still more important check resides in the provision (sec. 13) that Reserve Banks shall rediscount only "notes, drafts, and bills of exchange arising out of actual commercial transactions," having a maturity of not over 90 days; although a limited amount of live-stock paper may have a maturity not exceeding six months. The final definition of all such paper is left to the Reserve Board. But loans secured by investment security cannot be rediscounted. The spirit of the act, as already explained, forbids loans for carrying goods in storage for a higher price, and should confine loans to paper based on goods actually sold. Just how to define such paper lays a heavy responsibility on the Federal Board. On it will finally depend the kind of assets allowed to Reserve Banks.

4. A real restriction exists in making rediscounts on only short-time paper; but 90 days is somewhat too long for the best liquidity of assets. It was asserted, however, that country banks would gain no advantage by the new system, because they had little or no short-time paper. By the call of the Comptroller, August 9, 1913, it was disclosed that the national banks reporting held loans of $3,427,055,157 maturing in 90 days, and $2,594,351,440 maturing in a longer period; or 58 per cent of the former, and 42 per cent of the latter. The 6,736 country banks (outside central reserve and reserve cities) held $1,735,000,000 loans having a maturity of 90 days or less, and $1,337,000,000 maturing over 90 days. That is, even country banks hold more short-time than long-time paper. There is obviously enough paper to allow of expansion, so far as quantity goes. The real check must be in passing on the paper.

5. The exclusion of investment paper cuts off all possibility of expansion by stock exchange speculation through the help of rediscounts at Reserve Banks. It is to be remembered, however, that any member bank can still loan on stock-exchange collateral to the extent that it does not wish for rediscounts; and that all state institutions not members can loan on such collateral. We have not, therefore, seen the end of stock speculation.

6. Rediscounts at the Reserve Banks must be indorsed by the borrowing bank. Hence there will be some check here.

7. Also, no member bank may loan more than 10 per cent of its capital and surplus to any one person or firm. That is much the same now.

8. A real check is found in the restriction of discounts on acceptances to those based on importation or exportation of goods; and even these shall not exceed one-half the paid-up capital and surplus of the borrowing member bank.

The omission of domestic acceptances is a serious handicap to the desired discount market, but it works toward a restriction of potential expansion.

9. In practice the paper must pass rigid scrutiny in more than one step. First, it must satisfy the member bank; second, it must be satisfactory to the Reserve Bank; and, thirdly, if notes are wanted, it must pass the judgment of the Agent of the Reserve Board.

10. The power of the Reserve Board to examine into the operations of reserve banks, and the frequent or special examinations of member banks, will give an important control over expansion, or unsound banking, if legitimately used (secs. 21, 22, 23).

11. Again, it is to be noted that, in rediscounting, a large number of individual banks will be related to each other in a co-operative fashion. Something of an institutional character has been introduced, and it is possible to place responsibility here and there as was never possible before. This development should gradually and by experience prove of importance in controlling over-expansion.

12. Finally, if fear arises from the absence of any limit on note-issues, it is to be remembered that the Reserve Board can impose a tax upon them at their discretion, which tax will be added to the rate of discount to the borrower. Such a provision should accomplish the time-honored purpose of the European taxes on notes passing a certain limit. To remove all limits on notes was right; but it was a courageous thing to put it in the bill, because many people think expansion is largely to be attributed to the quantity of issues. In my opinion, trouble is less likely to arise from the notes than from the possible use of deposit-accounts following loans which demand only checks as a medium of exchange.

It must be emphasized that the possibilities of undue expansion of credit cannot be removed by any legal provisions in an act. It may create machinery, but the speed with which it will be run will depend upon the judgment of the man at the throttle. Elasticity of credit has been given us with all its possibilities of good to business, together with all its possibilities for abuse. The whole safety of our credit fabric, therefore, rests upon those who pass on the paper discounted. Consequently, the success of the new system depends primarily on the men selected to manage the several Reserve Banks. In practical operation, they are more important than those on the Reserve Board.

## XI

The new act has made possible a new departure of very great importance in the technical methods of clearings and collections.

How great a departure it is not possible yet to say. It is a further development of economizing devices in the settlement of credits. For a long time the charges of clearing-houses have been a source of dissatisfaction. The original field of clearing-houses was limited to local banks in one city, but now it is being extended somewhat by such a system as that inaugurated by Boston, Kansas City, and some other cities. In the new act larger questions of joint action over wide districts, or even over the whole country, are being raised. The problem is: Can the gains of city clearing-houses and collections be extended to the whole territory of the United States?

All the regulations touching this matter in the new act are as follows:

> Any Federal reserve bank may receive from any of its member banks, and from the United States, deposits of current funds in lawful money, national-bank notes, Federal reserve notes, or checks and drafts upon solvent member banks, payable upon presentation; or, solely for exchange purposes, may receive from other Federal reserve banks deposits of current funds in lawful money, national-bank notes, or checks and drafts upon solvent member or other reserve banks, payable upon presentation (sec. 13).
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> Every Federal reserve bank shall receive on deposit at par from member banks or from Federal reserve banks checks and drafts drawn upon any of its depositors, and when remitted by a Federal reserve bank, checks and drafts drawn by any depositor in any other Federal reserve bank or member bank upon funds to the credit of said depositor in said reserve bank or member bank. Nothing herein contained shall be construed as prohibiting a member bank from charging its actual expense incurred in collecting and remitting funds, or for exchange sold to its patrons. The Federal Reserve Board shall, by rule, fix the charges to be collected by the member banks from its patrons whose checks are cleared through the Federal reserve bank and the charge which may be imposed for the service of clearing or collection rendered by the Federal reserve bank (sec. 16).

In these sections, in spite of some blundering due to a compromise on technical questions, and from a desire to conciliate country banks (whose earnings are largely affected by charges for collections), some important advances were made: any Federal Reserve Bank may receive on deposit from its members or from the United States, checks and drafts drawn on any solvent member bank; "for exchange purposes" any Federal Reserve Bank may

accept from any other Reserve Bank checks and drafts drawn on any solvent member bank or other Reserve Bank; but it is said (sec. 16) that such items shall be received at par; while elsewhere certain charges are allowed for collecting them, which has been interpreted by exchange experts as making no charge for exchange, but allowing a charge for cost of service. But independent of "exchange purposes," any Reserve Bank must receive at par from member banks, or from other Reserve Banks, checks and drafts drawn on any member bank in the system, that is, without a charge for exchange; but yet a member bank is not to be prohibited from charging actual expenses for collection or exchange to its patrons.[1]

The Reserve Board is to fix the charges levied by member banks on patrons if these checks are cleared through a Reserve Bank, and also to fix the charge of the Reserve Bank for its cost of clearing or collection.

Bearing directly on a future system of clearings for the whole country, sec. 16 provides as follows:

> The Federal Reserve Board shall make and promulgate from time to time regulations governing the transfer of funds and charges therefor among Federal reserve banks and their branches, and may at its discretion exercise the functions of a clearing house for such Federal reserve banks, or may designate a Federal reserve bank to exercise such functions, and may also require each such bank to exercise the functions of a clearing house for its member banks.

Since a member bank will have reserves in its Reserve Bank, a balance in the clearings by a Reserve Bank against a member bank can be directly charged against the account of said member bank, and all charges for collection would be avoided. Any cost for handling these clearings could be charged by the Reserve Bank against member banks. A saving over the present methods is thus possible. How far a wide-reaching system of clearings may be developed, in spite of the extensive clerical service required,

[1] It has been pointed out by George Woodruff, *Journal of Political Economy*, April, 1914, p. 350, that the insertion of the words "when remitted by a Reserve Bank" prevents a Reserve Bank from receiving on deposit from its own members, or from the United States, checks and drafts drawn on any other Reserve Bank. That is, a member bank receiving a draft on a Reserve Bank other than its own cannot send it to its own Reserve Bank; although it can send in to its own Reserve Bank a check drawn on a member bank in another district.

depends largely on organization, and future dispositions. It is possible that the present city clearing-houses may be superseded.

It should be remembered, however, that, at present, only national banks (speaking generally) have joined the new system. There are more than twice as many banks out of the system as in it; and the relations of the national to state banks and trust companies must be reckoned with. The liabilities of the national banks to these outside institutions amount to over $1,200,000,000; while there is due from them to national banks a sum nearly half as large as from other national banks.

There is, under the new law, a discrimination in favor of a check drawn on any member bank: in the future it will be received at par in any part of the country equally with New York or Chicago exchange. Therefore all past methods of drawing exchange are to a certain extent likely to be upset. Certainly, checks on non-member banks will be discriminated against, and they must go through the old process of collection, which will not be so quick or so inexpensive as that of member banks. Competition of non-member banks may lower the cost, or checks on non-member banks may be collected by depositing checks of non-member banks with member banks.

The use of checks drawn by individuals on their local banks to make payments even of small sums in any part of the country lies at the bottom of the extensive system of collections and clearings in the United States. In Europe this burden is largely escaped by being thrown on remittances through banks. The new act clinches the present habit, and makes it permanent, by supplying the means of continuing it.

## XII

It had been hoped by the friends of the National Monetary Commission plan to introduce in this country a discount market such as exists in the financial centers of Europe. A discount market obviously means a market where certain kinds of paper can be sold at any time. To suit paper for such a market it must have universal acceptability, by having a maker whose credit is accepted in any market. Established institutions, rather than private persons, are likely to be thus recognized.

Promissory notes, the usual paper discounted in this country, are the promises of individuals or firms, and therefore have no wide recognition. The process of making an acceptance is as follows: The person wishing credits will go to a large mercantile house, or bank, and ask the privilege of drawing a bill on it, falling due at a date in the future, which will be accepted by them on presentation. The house, or bank, writes across the face of the bill the word "accepted," with the date and its signature. A promise to pay in the future to a bank and "accepted" by it has the security and recognition of the acceptor.[1] Hence, the use of acceptances has been urged as necessary to the existence of a discount market in this country.

Hitherto, acceptances have not been permitted by law to national banks. Under the new act our banks are allowed to accept, as follows:

> Any member bank may accept drafts or bills of exchange drawn upon it and growing out of transactions involving the importation or exportation of goods having not more than six months sight to run; but no bank shall accept such bills to an amount equal at any time in the aggregate to more than one-half its paid-up capital stock and surplus (sec. 13).

The limitation of acceptances to transactions in foreign trade, and the omission of authority to make acceptances based on domestic transactions, obviously limit the supply of paper which could be offered in a general discount market. The reason for such omission was the fear of undesirable expansion, if the right to accept were given free rein. In all cases the customer asking for the acceptance agrees to provide the accepting bank with funds to cover the acceptance a few days before it falls due. The acceptor only lends his credit, to the customer, and does not advance any cash. Hence in accepting a bill drawn on it, a bank would not create a liability in a deposit account against which it must carry reserves, and in this country the temptation to accept beyond moderation might have been too strong to be resisted, if a curb were not introduced. As the law stands, a limited use of acceptances is permitted, which may be extended by later legislation, provided

[1] For a useful description of the practical workings of acceptances, see Conway and Patterson, *op. cit.*, chap. xi.

traditions of safety may be hereafter established. Moreover, it is doubtful if bills of exchange drawn on the actual exchange of goods, or bills drawn on banks, in order to provide acceptances could be extended to such an extent in this country as to supplant the promissory note.

Besides the general market for acceptances, the new act permits Federal Reserve Banks to deal in them:

> Any Federal reserve bank may discount acceptances which are based on the importation or exportation of goods and which have a maturity at time of discount of not more than three months, and indorsed by at least one member bank. The amount of acceptances so discounted shall at no time exceed one-half the paid-up capital stock and surplus of the bank for which the rediscounts are made (sec. 13).

If our acceptances based on cotton, for instance, were made salable in London, or on the Continent, they would in effect provide a means of bringing in foreign capital to finance the movement of our crop. This would be an obvious advantage.

In other respects, the purpose of selling acceptances in a discount market would be to change the assets of the holder into cash. So far as member banks wish to do this, they may obtain the end in another way, by rediscounting paper with a Federal Reserve Bank; but such operations are limited by the resources of capital at the disposal of the Reserve Banks.

## XIII

So far as Americans are engaged in foreign trade, or are located in foreign countries, they labor under some disadvantage, if they are obliged to do their business through foreign banking institutions. In international relations, and in granting of loans, the trade of any one country is usually favored by the institutions owned by the citizens of that country. Our business men are not so well known that they can obtain loans from foreign banking houses in Buenos Aires or Hongkong as favorably as those who have been long known to the commercial and banking institutions. A young country must fight for its recognition in trade; and it needs the support abroad of its own powerful banking institutions.

Moreover, American bankers are now obliged to share com-

missions with foreign bankers on an immense amount of international trade originating with us. At present American drafts and bills, if sent abroad in payment of imports from Europe, could not be sold in the discount markets of Europe, because the American firms are not sufficiently well known.

As soon as our foreign trade warrants it, and as soon as we have capital enough to be employed out of the country, foreign banking branches, if profitable, will come into being under the provisions of the new act (sec. 25). Such branches are permitted to national banks having a capital and surplus of $1,000,000 or more, subject to examination by the Federal Reserve Board, and provided the accounts of each branch are kept separately from those of any other branch.

There are many other matters which might be touched upon in connection with the new law; but within the space allowed it has been possible to discuss only the chief topics selected. There are unfortunate provisions in the act, such as those in sec. 24, permitting loans on farm lands by banks that create demand liabilities. They should not tie up their resources in an unliquid form like land. But the sum and substance of the whole act is so remarkably good, that the combined support of both bankers and the public is certain to be given to it to the end that it may work smoothly and bring a long-desired reform to an expectant nation.

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